

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA

In re  
James and Dorothy Harrison,  
Debtors.

Case No. 95-55593 MM  
Chapter 7

BFR ASSOCIATES DBA DIAMOND  
WELL DRILLING COMPANY; ARTHUR  
D. FULTON,  
Plaintiffs,  
vs.  
J.G. HARRISON, DOROTHY HARRISON,  
ANNA P.K. VAN SERGAE and DOES I-X  
Defendants.

Adversary No. 94-5-5326

**MEMORANDUM OPINION AND ORDER THEREON**

**INTRODUCTION**

This proceeding concerns the debt of James and Dorothy Harrison incurred during their chapter 11 case for well drilling services in developing their unimproved property in Monterey County. The complaint of BFR Associates seeks to except the amount of \$52,892.34 from the Harrison's chapter 7 discharge. For the reasons set forth, the Court holds this debt is non-dischargeable under 11 U.S.C. § 523(a)(2)(A).

**FACTS**

At the time of their Chapter 11 filing, the Harrisons owned several tracts of land including a

1 resort property in Clearlake, California, a ranch in Watsonville, California, several residential rental  
2 properties in Richmond and Berkeley, California, and approximately 400 acres of unimproved land,  
3 referred to as Chualar Canyon, in Monterey County, California. The Harrisons are sophisticated real  
4 estate investors who currently reside in Honolulu, Hawaii, where James Harrison also maintains a  
5 psychiatric practice. The facts underlying this complaint relate to the Harrisons' abortive efforts to  
6 develop Chualar Canyon. They appointed their daughter, Anna Van Sergae, as their attorney-in-fact  
7 with powers limited to the development of Chualar Canyon. They also hired Richard J. Pryor, a real  
8 estate development consultant, to supervise construction and development of the project. It was  
9 critical to the development of Chualar Canyon to locate a water source on the property sufficient to  
10 satisfy Monterey County subdivision requirements. However, several drilling contractors approached  
11 by the Harrisons refused the work when they became aware of the Harrisons' financial problems.

12 When Van Sergae contacted the plaintiff, BFR, on behalf of the Harrisons, BFR forwarded a  
13 copy of its standard contract for review. Just hours after the Harrisons filed a Chapter 11 petition,  
14 Van Sergae requested proof of BFR's Workers Compensation Insurance. Upon receiving assurance  
15 that insurance was in place, Van Sergae indicated to a BFR representative that the contract "was  
16 acceptable" and that a signed copy of the contract would be faxed to the company. Shortly  
17 thereafter, the BFR representative received a fax transmission of an executed contract from the  
18 Harrisons. As BFR later discovered, the first and final two pages of the contract were identical to the  
19 contract provided the Harrisons, but the middle pages contained material alterations. Van Sergae  
20 never disclosed that she had significantly altered BFR's standard contract.

21 Most significant among the alterations were:

- 22 1. BFR's contract provides that payment must be received before BFR would release water  
23 reports. The altered contract provides for payment only after receipt of the water reports.
- 24 2. BFR's contract requires that the land owner consent to a mechanic's lien on the property in  
25 the event of non-payment. The altered contract removed this provision.
- 26 3. BFR's contract provided that BFR would be held harmless regarding the consequences  
27 arising out of the quantity or quality of water produced by the well. The altered contract also  
28 removed this provision.

1 Neither Van Sergae nor the Harrisons disclosed to BFR the Harrisons' Chapter 11 filing.  
2 Unaware of the material alterations to the BFR contract as well as the Chapter 11 filing, BFR's  
3 representative signed the contract committing to drill a water well to a depth of three hundred feet.

4 On October 7, 1991, BFR completed a well to a depth of four hundred and thirty feet.  
5 Despite the fact that the contract required modifications to be in writing, the Harrisons orally  
6 authorized a change order to drill beyond three hundred feet and use a more expensive casing  
7 material. This well did not produce water sufficient to support the planned development. When the  
8 Harrisons came to inspect the first well with Van Sergae, they authorized BFR to cap this well and  
9 drill a second one. On October 18, 1991, after work on the second well began, BFR learned of the  
10 Harrisons' bankruptcy filing. Thereafter, Van Sergae orally assured a representative of BFR that it  
11 would be paid and authorized drilling the second well to a depth of five hundred and fifty feet. BFR  
12 completed the second well on October 22, 1991. This well also failed to produce sufficient water to  
13 support the planned development. When the Harrisons were unable to locate water to support a  
14 subdivision, the project failed.

15 A chapter 11 trustee was appointed for the estate on June 5, 1992. The trustee abandoned  
16 Chualar Canyon on September 17, 1993 before the property was foreclosed by a secured creditor.

17 The procedural posture of the case arrives after a litigious history. On February 6, 1992, BFR  
18 filed a complaint against the Harrisons in the Superior Court for Monterey County to foreclose on its  
19 two mechanic's liens in the amount of \$30,698.62. The Harrisons filed a counterclaim alleging BFR  
20 failed to complete a water-producing well and failed to seal the drilled wells. The Harrisons  
21 stipulated to relief from the automatic stay to liquidate BFR's claim in Superior Court. However,  
22 BFR removed the Superior Court action to this Court. Trial of the removed action was held on July  
23 28, 1993. Although the Harrisons were served with and answered the complaint, they failed to  
24 appear at the time of the trial, only sending Anna Van Sergae as their attorney-in-fact.

25 The Court found that the Harrisons' contract with BFR was made in the ordinary course of  
26 business but did not benefit the estate. Judgment was entered against the Harrisons for breach of  
27 contract in the amount of \$30,693.62 plus pre-judgment interest, attorneys' fees and costs amounting  
28 to \$22,198.72. Shortly thereafter, the case was converted to chapter 7, resulting in this proceeding

1 for non-dischargeability.

2 The issue before the Court is whether, by their silence regarding the alterations to the contract  
3 and their ability to pay, the Harrisons materially misrepresented their intent in contracting for services  
4 from BFR.

### 5 DISCUSSION

6 Section 523(a)(2)(A) of the Bankruptcy Code provides that an individual debtor is not discharged  
7 from any debt for services to the extent obtained by false pretense, false representation, or actual fraud.  
8 To succeed in its claim, BFR must prove the following by a preponderance of the evidence: (1) the  
9 Harrisons made representations; (2) that they knew to be false, or that they acted with reckless  
10 indifference to the truth; (3) the representations were made with the intent and purpose of deceiving BFR;  
11 (4) BFR justifiably relied on the representations; and (5) BFR sustained damages as a proximate result  
12 of the representations. Field v. Mans, \_\_\_ U.S. \_\_\_, 95 C.D.O.S. 8949;8951 (1995); In re Britton, 950  
13 F.2d 602, 604 (9th Cir. 1991); Grogan v. Garner, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991);  
14 In re Rubin, 875 F.2d 755, 759 (9th Cir.1989).

#### 15 A. False Pretense or Representation

16  
17 At the crux of this proceeding is the court's determination that the Harrisons' negotiations with  
18 BFR contained implied representations and conduct intended to create and foster a false impression  
19 regarding the contract and payment. The Court reaches this result for the following reasons. The  
20 Harrisons' previous negotiations with other drilling contractors failed due to the Harrisons' financial  
21 problems. Yet, despite preparation of a chapter 11 petition, the Harrisons never disclosed their financial  
22 situation. Only hours after filing the chapter 11 case, the Harrisons advised a BFR representative that  
23 the contract "was acceptable." Clearly, however, BFR's standard contract was not acceptable to the  
24 Harrisons because the contract was redrafted such that (1) the Harrisons would receive the drilling  
25 reports before payment to BFR was due; (2) no lien could be placed against Chualar Canyon; and (3)  
26 BFR would not be held harmless regarding the results of the drilling. These revisions were sandwiched  
27 in the middle of BFR's contract. By advising the BFR representative that the contract "was acceptable,"  
28 the Harrisons misrepresented their intentions. Thereafter, the Harrisons maintained silence regarding

1 these material alterations as well as their bankruptcy filing.

2 The Court may infer an intent to deceive from a misrepresentation. In re Rubin, 875 F.2d at 759.  
3 Where the debtor perpetrates the misrepresentation through silence or nondisclosure, intent to deceive  
4 may be inferred from the fact that the debtor received some benefit that he would not have obtained  
5 absent his silence, and remained silent despite the knowledge that the creditor would bear any resulting  
6 loss. In re Demarest, 176 B.R. 917, 920 (Bankr. 9th Cir. 1995).

7 The Harrisons knew their misrepresentation would mislead BFR into believing the Harrisons  
8 signed BFR's standard contract and that the Harrisons would pay for services rendered under that  
9 contract. However, the Harrisons were insolvent, and the contract alterations appear to have been  
10 intended to shift the cost of drilling to BFR in the event that a sufficient water supply was not found.  
11 Thus, the Harrisons gained the benefit of the water reports that determined the viability of further  
12 development and shifted the risk of loss to BFR.

13 B. Intent to Deceive

14 The Harrisons assert that they intended to pay BFR both when they entered the contract and when  
15 they authorized the change orders. However, it appears, at best, that the Harrisons' only intended to pay  
16 BFR if BFR found water sufficient to allow development of the parcel. Although all acts giving rise to  
17 the inference of intent to deceive are attributable to Van Sergae, those acts were originally authorized  
18 by, and subsequently ratified by, the Harrisons.

19 The intent to deceive required for a finding of non-dischargeability can be inferred from  
20 surrounding circumstances or a false representation. In re Hultquist, 101 B.R. 180, 183 (Bankr. 9th Cir.  
21 1989); In re Rubin 875 F.2d at 759. The Harrisons intent to deceive BFR can be inferred from the  
22 Harrisons' alteration of the material terms in the contract, their continued silence regarding these terms  
23 and their financial insolvency.

24 C. Justifiable Reliance

25 At trial BFR's principal testified that he would not have signed the contract had he known the  
26 Harrisons had included material alterations between the pages of BFR's standard contract. The requisite  
27 level of reliance under §523(a)(s)(A) is justifiable reliance. Field v. Mans, 95 C.D.O.S. at 8951. One is  
28 "justified in relying on a representation of fact 'although he might have ascertained the falsity of the

1 representation had he made an investigation.'" Id. (quoting Restatement (Second) of Torts (1976)). BFR  
2 relied upon the Harrisons' representations that the contract "was acceptable" and that they would  
3 compensate BFR for its services. BFR was not obliged to investigate the veracity of the Harrisons'  
4 representations. Field v. Mans, 95 C.D.O.S. at 8951; In re Apte, 180 B.R. 223 (9th Cir. BAP 1995);  
5 In re Ashley, 903 F.2d 599, 604-05 (9th Cir. 1989).

6 D. Damages Sustained as Proximate Result

7 Unaware of the Harrisons misrepresentations, BFR performed services worth \$30,693.62 and  
8 incurred a further loss of \$22,198.72 for interest, attorneys' fees and costs. There can be no question that  
9 the damages suffered by BFR to the extent of \$30,693.62, the amount owed BFR on the drilling contract,  
10 were a direct consequence of the Harrisons representations.

11 A bankruptcy court has authority to apply state or federal substantive law, depending on the  
12 nature of the action. Where state law governs the substantive issues in an action, the bankruptcy court  
13 is required to look to state law to determine whether attorney's fees should be awarded. In re Johnson,  
14 756 F.2d 738, 740-41 (9th Cir. 1985); In re Ashley, 903 F.2d at 605 n. 7 (9th Cir. 1990).

15 California law provides that attorney's fees shall be granted where the contract so provides.  
16 Cal.Civ.Code §1717. Thus, attorney's fees, costs and interest of \$22,198.72 are held non-dischargeable  
17 under Section 523(a)(2)(A). There has been no further request for attorney fees and the Bankruptcy  
18 Code does not provide for allowance of attorney's fees and costs in connection with a dischargeability  
19 action except as provided in §523(d).

20 **CONCLUSION**

21 For the reasons stated, the the Harrisons debt to BFR in the amount of \$52,892.34 is non-  
22 dischargeable.

23 Accordingly, IT IS SO ORDERED.

24  
25 DATED:

UNITED STATES BANKRUPTCY JUDGE